Transnationals

Quarterly Newsletter of the
United Nations Centre on
Transnational Corporations

INVESTMENT FLOWS $150 BILLION IN 88

Growth Led by Japan and Smaller Investors

World-wide flows of foreign direct investment continued to expand in 1988, reaching $150 billion. The two largest home countries invested less than the year before. However, a number of smaller investors registered significant increase, carrying the current expansion of world investment through the sixth year.

The current expansion, which started in 1982 and tripled in 1984-87, has slowed considerably. Total investment outflows increased only 4 per cent in 1988. Sharp drops in US outflows of $26 billion and UK outflows of $4 billion were largely responsible. The United States and the United Kingdom normally account for 40 per cent of world flows.

However, these drops were offset by a significant increase in outflows from Japan, France, Canada and other home countries. Most striking was the $12 billion surge in outflows from the smaller investors of Western Europe — Switzerland, Italy, Sweden and Finland.

Outflows from developing countries also grew markedly. Led by Asian countries (Taiwan, Province of China, in particular), total outward investment doubled to $5.8 billion in 1988. The share of developing countries in total outflows remains just 4 per cent, however.

Continuing earlier trends, 83 per cent of all foreign investment went to developed countries. There was strong growth of inward investment in the United States, the largest host country (absorbing $58 billion or 41 per cent of total inflows). Much of the increase was also directed to Western Europe, in preparation for the single market in 1992.

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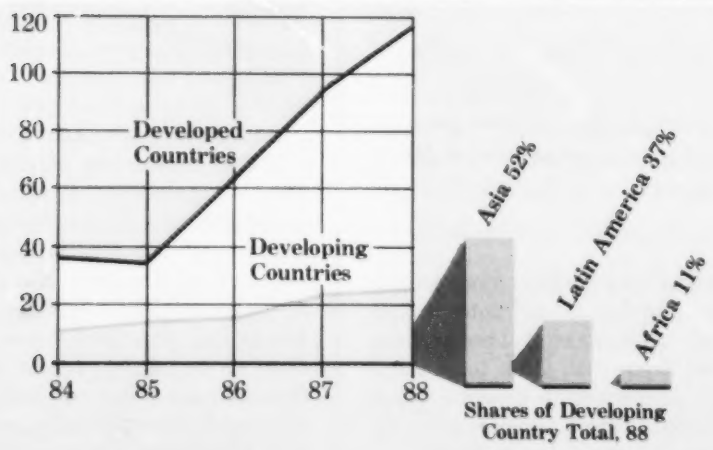
Foreign Direct Investment

(Annual inflows, billions of dollars)



Soviet Enterprises Given Green Light to Invest Abroad

Last year, the Soviet Union enacted a decree allowing state-owned enterprises, co-operatives and other organizations to set up foreign economic operations and to trade in stock and commodity exchanges abroad. The move is designed to facilitate the country's further integration into the world economy and to promote Soviet goods in foreign markets. Other Eastern European countries are also considering similar regulation.

Already, Eastern European enterprises abroad are important instruments for East-West business. Their numbers have grown, as has the range of their activities.

There are 862 Eastern European enterprises abroad, more than twice the number 10 years ago. More than half are located in the OECD countries, with an investment value of some $876

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Investment Flows

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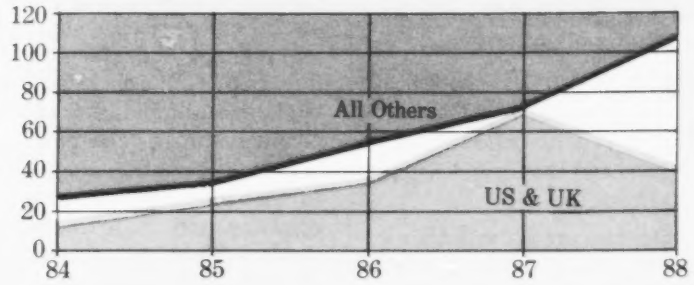
Developing countries attracted inflows of $25 billion in 1988, a 7 per cent growth over 1987. All regions recorded an increase except Latin America, where inflows declined by $1.5 billion. More than half of Latin America's inflows involve debt-equity conversions.

Asia has now overtaken Latin America as the largest host region among developing countries. However, that could prove temporary as 26 per cent of Asia's 1988 inflows went to China, which has since experienced a major decline.

In relative terms, the share of developing countries continued to drop. In 1981, they received 26 per cent of total inflows; in 1988 only 17 per cent. Their share likely fell further in 1989, with the drop in flows to China.

Investment Outflows from Home Countries (billions of dollars)



Perhaps the most strategic development of the past two years is the rapid emergence of Eastern Europe and the USSR as prospective hosts for foreign direct investment. All countries of that area have introduced or improved laws and regulations aimed at attracting foreign investment. Additionally, Bulgaria, Hungary and Poland have established free economic zones (the USSR may establish the first of several zones this year).

In 1989, the number of joint-venture agreements signed with Soviet firms increased four-fold: these 1200 joint ventures involve commitments (possible future investments) of more than $4 billion. In other Eastern European countries, the number of joint ventures in Hungary doubled last year to more than 600, and in Poland, 850 agreements have been approved in the last two years. These developments are likely to be important in future investment flows. ■

Soviet Enterprises

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million. The Federal Republic of Germany is the most popular host country, with one fifth of the enterprises. Developing countries host about 268 of the enterprises. Hungarians, Polish, and Soviet enterprises are the most active foreign investors.

But this "transnationalization" is quite different from that experienced by the developed market economies. Till a few years ago, foreign affiliates of Western and Japanese firms were concentrated in manufacturing and extractive industries, making little investment in services industries. Eastern European affiliates, on the other hand, have been in services from the start, gradually engaging in extractive and manufacturing activities. In developing countries, manufacturing and primary production are relatively more prominent. Further, the affiliates tend to locate in countries that have strong trade links with their home economy, in contrast to Western transnationals, which also operate in diverse and unrelated markets.

Unlike Western transnationals, affiliates of Soviet enterprises have been in services from the start.

The majority of Eastern European enterprises were set up with government help as export promotion agencies and traditionally engaged in trade and trade-supporting activities. But to enhance their competitive position, larger marketing and trade enterprises have also moved into transport, distribution, technical servicing and manufacturing. Product servicing and the fine-tuning of exported goods to meet Western tastes and specifications is another important activity. 69 per cent of the total number of Eastern European affiliates in OECD countries are in marketing, distribution and technical servicing; 26 per cent are in financial and other services; 6 per cent are in manufacturing, extraction, processing and assembling.

Many enterprises also buy supplies for companies at home. Like the Polish-British firm, Polibur Ltd., some are established expressly to buy Western products for the home market. This "on the spot" purchasing is important as it ensures a stable supply of necessary imports while significantly reducing transaction costs.

Most enterprises provide a variety of services to Western clients for a fee. These range from

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advice on key developments in Eastern markets, assisting Western companies in negotiations, and representing them before regulatory agencies or prospective buyers at home.

Banking and financial services are among the largest operations abroad. The Soviet banks in London and Paris are, even by industry standards, big. The Moscow Narodny Bank in London, for instance, has assets of about £2.3 billion. The prime focus of those banks is financing East-West trade, and lending to Western borrowers through the Euromarket. Like the Hungarians and Romanian banks, many are also looking beyond trade to international leasing, hire purchase and asset financing. Firms like Centrobank in Vienna, and the Hungarian International Bank in London specialize in countertrade financing, where sales of Western goods are matched to the purchase of Eastern European products.

Though these enterprises show a preference for majority ownership, especially in developed countries, joint-venture and counterpart trade arrangements are springing up with Western partners. Under those types of arrangement, foreign partners help Eastern European enterprises in their countries sell in local markets. In return, those enterprises help improve the competitive position of the Western companies in the newly opened Eastern European markets. One example is Hungaroswiss, a Swiss venture with Hungarian partners and based in both Zurich and Budapest.

Overall, the share of Eastern European foreign direct investment in total world flows is minimal. However, the material contributions of enterprises abroad, their established infrastructure overseas, and their long history of dealings with the West make them invaluable in the economic restructuring in process at home. With the new legislation, the number of affiliates should grow; so should the scope for external collaboration. ■

US-Canada Trade Agreement Spurs Investment North

The United States-Canada Free Trade Agreement, signed in January 1989, removes tariffs and non-tariff barriers and liberalizes cross-border investment. The investment measures provide national treatment rights (foreign firms cannot be treated less favourably than domestic firms) and lift performance requirements for foreign investors.

US investment in Canada ($61 billion) is twice as large as Canadian investment in the United States. Moreover, surveys of corporate capital expenditure plans indicate that the Agreement is having a positive influence on northbound investment, at least in the manufacturing sector.

At the same time, the Agreement is expected to slow down southbound investment from its present annual growth rate of 20 per cent. The reason: pre-Agreement investment was driven by a need to secure market access in the face of rising US protectionism. That need should now subside.

Investment in Canada from third countries will also likely increase in the long-term. While the Canadian market is relatively small, many large regional markets in the United States can be profitably served from a Canadian base (provided high local content requirements are met).

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Debt-Equity Swaps: Best for None, Right for Many

Making the best of a bad situation is how both debtor countries and creditor banks would describe debt-equity swaps. Yet, an increasing number of debtors and creditors are taking the debt-equity route: strict debt-equity conversions in 1984-89 amounted to $22 billion; more than half in the past two years alone.

By now, several hundred deals have been struck in at least two dozen countries. They have involved long-established US corporations (Chrysler, Ford, Eastman Kodak), the Japanese (Nissan, JAL) and Europeans (Fiat, VW, Shell, Club Méditerranée) as well as relative newcomers from other areas, for example, Carter Holt Harvey and Fletcher Challenge from New Zealand. The majority of the companies were already active in the countries involved. Mexico, Brazil, Chile, Argentina and the Philippines, in that order, account for 90 per cent of the conversions so far, but Costa Rica, Ecuador, Honduras, Jamaica, Nigeria, Uruguay and Venezuela also have had active programmes.

The debt conversion business has given rise to a major growth sector within the banking industry.

In more-or-less typical deals, Chrysler expanded its Mexican auto assembly operations in 1986 by buying over 25 per cent more pesos for its money than it would have done at the official rate, and the Government was able to cancel foreign debt with a face value of $50 million. In 1988, Royal Dutch/Shell, Scott Paper and Citibank converted $277 million of Chile's debt paper for a stake in a pulp plant at an effective savings of 30 per cent from the official exchange rate.

The debt conversion business has also given rise to a major growth sector within the banking industry. More than 50 commercial and investment bank intermediaries in creditor countries have departments to deal in debt swaps. Total volume (taking into account the "chain" nature of most deals) is probably close to $20 billion a year.

Debt Reduction or Investment?

Most creditor Governments and institutions tend to see debt-equity programmes primarily as a way of reducing indebtedness. In debtor

Debt-Equity Swaps

PROS	CONS
Country	
Encourages capital inflows	Limited additionality in capital inflows
Spurs economic growth and technology transfer	Misallocation of resources (through preferential exchange rates)
Substitutes foreign exchange obligation for local currency lien (dedollarization)	Inflation (when debt repurchased through money creation), interest and exchange-rate pressures
Reduces immediate debt-service costs	Profit repatriation over long-term
Transfers risk (with an equity obligation that only incurs service costs if the investment is successful)	Round-tripping (speculators convert swaps back into foreign exchange) and other speculative practices
Encourages repatriation of flight capital (when residents participate in swaps)	Permits capital flight (when domestic investors sell existing assets to foreigners)
Fosters private sector initiative and can support privatization (creating new demand for swaps)	Fear of foreign domination
Creditor	
Realign portfolios	Accounting loss
Provides cash	Loan loss provisions
Write-off non-performing assets	Legal risks
	Tax considerations in US
Investor	
Subsidy to invest; windfall if would have invested anyway	Complex and time-consuming, with high fees

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countries, however, the main pressure to establish conversion programmes has tended to be the dearth of foreign or domestic investment.

Even in Chile, where there has been a major impact on the stock of foreign debt, the initial motivation was to facilitate the return to the private sector of companies that had been "intervened" in the mid- to late 1970s. In countries like Mexico, Jamaica and the Philippines, the investment orientation is even more apparent.

One reason: a debtor country has the option of not servicing its external debt (and many have fallen into arrears on interest payments); but it does not have the option of choosing the level of investment, either domestic or foreign. Hence the need for incentive schemes, such as debt-equity programmes, or indeed any form of preferential treatment for foreign investors.

Investments generated by debt-equity swaps, while limited, have been relatively significant in some cases. Conversion of only 7 per cent of Mexico's debt accounts for more than one half of foreign inflows since 1982. By 1987, investment flows had resuscitated to 1980-1981 boom levels or better.

Country Experience

Paradoxically, there is only limited evidence that a long-term commitment to foreign investment is a necessary pre-condition for a successful debt-equity programme. Chile and more recently Mexico are two clear examples of a successful programme linked to the Government's broader pro-foreign investment orientation. But the case of Argentina — which has long been suspicious of foreign investment — suggests that some limited success can be attained with the stick as well as the carrot.

In the case of countries like Argentina, the absence of alternatives (and the prospect of debt not being serviced on time) has prompted creditors to utilize the debt-equity programme as the "least bad" policy option open to them — one that, if nothing more, holds open a possibility that they will not have to accept the major write-off of their Argentine exposure that they would so much like to avoid.

The most successful country programmes are those where investors see an immediate market opportunity.

Thus, while investors certainly respond to the general investment climate, less attractive business opportunities have also been taken up, as creditors may offer supplemental inducements or make the investments themselves. However, a swap incentive will not normally make or break a decision to invest in a given country. The most successful programmes appear to have been those where potential investors see an immediate market opportunity.

By and large, the debt-equity route has been less accessible to smaller debtor countries. They do not have the leverage enjoyed by the bigger debtors *vis-à-vis* creditor institutions. Also, there are not many smaller debtor countries that can offer transnationals either a major domestic market or access to a larger regional market. This is a major reason for the mixed success of the Jamaican debt-equity programme to date.

New Swap Types

- **Debt-for-trade schemes** favour creditors who are willing to accept goods as well as cash. Peru requires banks to pay $2 in cash for every $3 worth of goods. The $1 difference retires short-term debt.
- **Debt-for-nature schemes** convert debt into local currency to be spent on environmental projects. Bolivia, Costa Rica, Ecuador, the Philippines, Zambia and Madagascar have "eco-swap" programmes.
- **Debt-for-development schemes** donate debt to relief agencies which redeem it for local currency to fund development programmes. In 1988, Midland Bank gave the United Nations Children's Fund $800,000 of Sudanese debt to fund drought relief efforts.

Overall, the ideal debt-equity conversion is one which mobilizes incremental foreign investment for the export sector and establishes opportunities for local ownership. Those conditions might be met in the context of comprehensive policy reforms to improve the investment climate of the host country. Moreover, the adoption of market-oriented reforms within special zones could reinforce initiatives while minimizing political opposition.

Many observers have correctly noted the importance of simplicity, transparency, continuity, and a credible and reliable legal framework, and have rightly pointed out that it is easier to tighten up rules that start out flexible than to try to relax rules if a programme's initial

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Corporate Strategies for a "Borderless" Europe

As companies scramble to prepare for the single European Community market in 1992, a new industrial landscape is taking shape in Europe which, in the long-run, promises to make European firms more competitive. But will US and Japanese transnationals already in Europe benefit more initially than European companies themselves?

Since the late-1950s, European firms, particularly in high-tech industries, have progressively lost ground to their American and Japanese competitors at home and abroad. Market unification is intended to reverse that trend. The opening up of national goods, services, labour and capital markets will greatly enhance the potential for intra-regional trade and investment, and strengthen the competitive position of European countries.

The 1992 unification programme extends national competitive strength to the international level: regionally oriented firms will profit from lower costs and larger markets. However, a company strong in its home market may need to establish positions in several neighbouring countries in order to survive in the barrier-free market. Firms which do not implement cross-border strategies risk being squeezed out by firms that do.

That prospect has already unleashed an unprecedented wave of business activity within the Community, as companies restructure and position themselves for 1992. The number of mergers and acquisitions (involving the Community's top 1,000 firms) tripled between 1984 and 1988, to nearly 500 per year. Cross-border deals represent over 40 per cent of the transactions in 1988; in terms of value, corporate assets in Europe are largely traded across, rather than within, national borders.

Earlier, European transnationals tended to focus on a small number of markets and to grow within them by diversifying product lines. Now many European companies are emphasizing core businesses in their expansion strategies. For example, Philips, one of Europe's largest electronics corporations, recently restructured from a collection of autonomous national subsidiaries to an integrated set of Europe-wide, product-based companies. Others are similarly busy shuffling assets or establishing cross-border strategic alliances.

However, firms from outside the Community are also rushing to make new investments and acquire new businesses. Europe attracted a quarter of world investment flows in the 1980s, and corporate strategies call for increased capital expenditures in the immediate future: according to one survey, US transnationals plan to invest $23 billion in their European affiliates in 1990. A third of all European cross-border mergers and acquisitions involve foreign firms.

US transnationals have been major investors since the 1950s. Europe accounts for 25 per cent of US global sales of goods and services, and much of this business (85 per cent) is served by US affiliates in Europe, with only 15 per cent through direct exports. Thus, the challenge facing US transnationals is not so much to secure entry, but how to reorganize and restructure European operations to consolidate positions in fast-growing market segments. For example, Coca-Cola, with 80 per cent of the European market, is rationalizing purchasing operations from four sources to one, reorganizing distribution networks along regional lines, and investing over $100 million in new European plants.

In contrast, Japanese companies have traditionally serviced the European market primarily through exports (80 per cent). In the last five years, however, there

1992: A New Industrial Landscape

There are no tariffs and quotas within the European Community but non-tariff barriers are high. Market unification would eliminate those barriers and permit an integrated industrial base, yielding in the medium term benefits estimated up to 30 per cent of the Community's gross domestic product or over $1 trillion.

Industries such as telecommunications, pharmaceuticals, automobiles, defence electronics, processed foods and data processing, are expected to realize substantial gains from rationalization of production, marketing and distribution networks. Services such as insurance, banking and transportation are also likely to undergo consolidation.

Industrial restructuring is expected to bring about large European corporate groups active in the entire Community, with some becoming important competitors in global markets as well.

has been a surge of Japanese direct investment into Europe, fuelled by the prospect of a single internal market and also by uncertainty as to the European Community's future external policy.

US and Japanese transnationals already treat Europe as a single market in their investment strategies.

The way Japanese transnationals are organizing their production facilities is one indication of how European industry might look in the future. Nissan, for instance, now operates a design centre and an assembly plant for passenger cars in the United Kingdom, an assembly plant for commercial vehicles in Spain, a continental distribution centre in Belgium, and locates its regional headquarters and service centres in the Netherlands. Japanese transnationals are also beginning to serve global markets from Europe.

US and Japanese transnationals might be better equipped for 1992 in that they already treat Europe as a single market in their investment strategies. Their organizational, technological and sheer size advantages may even mean that market unification could have the unintended effect of benefitting foreign transnationals more than domestic firms.

UNCTC, in co-operation with the European Community, is studying the effects of integration on investment in developing countries, and interviewing corporate executives to determine their game plans for 1992. ■

US-Canada

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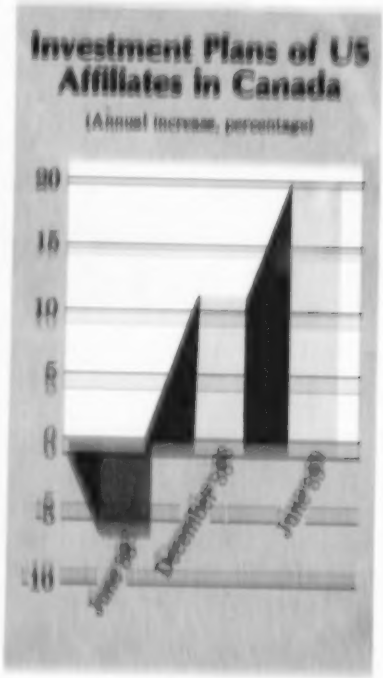
Investment in developing countries could be hurt in some industries. For example, several developing countries supply automobile parts and/or assembled vehicles to North America. The Agreement encourages third-party carmakers to invest directly in North America rather than export there. It also encourages such investment to incorporate less developing country valued-added than if there had been no Agreement.

However, Canada's comparative advantage in natural-resource processing and capital-intensive



industry rather than in assembly-type light manufacturing, means that it does not pose a significant threat to export-oriented investment in many developing countries.

Transnationals from developing countries also are expected to invest in Canada, now that they are assured of duty-free access to all of North America. In September 1989, the Gerdau Group of Brazil purchased a Canadian steel mill for $52 million, thereby accessing state-of-the-art steel-making technology while bypassing US quotas on Brazilian steel. ■

Debt-Equity Swaps

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rigidity kills off potential investor interest.

Whether a debt-equity programme is a good thing ultimately depends on the political, economic and social situation in each country. Creditor banks face an equally complex cost/benefit calculus: debt conversions are not an unequivocally "good" or "bad" thing for them either.

Debt conversions have a long way to go even to offset new debt creation: only 8 per cent of the total external debt of highly indebted countries has been converted to equity. However, the surge in the past two years suggests that some of the opposition to swaps has either dissipated or has been subordinated to the more pressing needs of reducing the debt burden and increasing investment.

UNCTC has organized training workshops and seminars for government officials on the financial aspects of foreign investment, particularly involving negotiations with transnational banks. This work has also involved assistance on topics related to debt management and debt reduction.

In 1988, UNCTC, in co-operation with the Latin American Economic System, sponsored a seminar in Caracas, Venezuela on debt-equity conversions. A handbook is forthcoming entitled *Debt-Equity Conversions: A Guide for Decision-Makers.* ■

NEW PUBLICATIONS

Transnationals Lead Developing Countries into World Markets

Developing countries increased their share in world exports of manufactures from 11 to 14 per cent in the last 20 years. Transnationals were important to this advance, according to a recent study of the role of foreign affiliates in the export competitiveness of developing countries.

Transnationals have been key exporters of manufactures in many developing countries in the sense that their exports grew faster than those of their host countries.

Their role has been notable in Latin America, where foreign affiliates have increased their exports rapidly since the mid-1960s, while at the same time, Latin American firms lost export shares. After the 1982 debt crisis, when local demand fell dramatically, exports of US affiliates as a percentage of total sales almost doubled (they more than tripled in Mexico).

The Asian newly industrializing countries (NICs) performed very differently. They not only increased their share of world manufactured exports, but did so at a faster rate than US affiliates located there. Thus, trade policy and other factors may be more important than foreign investment for successful export-oriented manufacturing.

Transnationals have made their largest contribution in industries that are relatively technology- and marketing-intensive, and in industries with labour-intensive production. In other less sophisticated industries, such as textiles, developing countries have been fairly successful on their own.

Japanese firms appear to bring less of the comparative advantage of the home country to host developing countries than do others. For instance, exports of US and Swedish affiliates were distributed more like home-country exports than developing-country exports. Japanese affiliates, on the other hand, exported products that were very different from Japanese exports and much more similar to those of the developing countries.

The study also shows that transnationals have shifted production to their foreign affiliates over the years, in order to export from abroad rather than from the home country. In this way, both production and trading activities of transnationals tend to become diffused over the entire world economy. ■

Transnational Corporations and Manufacturing Exports from Developing Countries, by Magnus Blomström. Published in English. Available in April 1990. Copies may be obtained from the United Nations, Sales Section, New York or Geneva.

The United Nations Centre on Transnationals is an autonomous body within the United Nations Secretariat. Under the guidance of the Commission on Transnational Corporations, an intergovernmental subsidiary organ of the United Nations Economic and Social Council, the Centre seeks to further understanding of the nature of transnational corporations; to secure effective international agreements; and to strengthen the negotiating capacity of host countries, in particular the developing countries.

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